

Comments

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A New Vehicle for Mission-Driven Work: Is the Low-Profit Limited Liability Company Right for Oregon?

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INTRODUCTION

During the 2011 legislative session, the Oregon House of Representatives considered a bill that would create a new category of limited liability company (LLC) with a specified primary objective of furthering a charitable purpose.¹ In so doing, Oregon joined a list of multiple states that have already passed or considered legislation creating this type of business entity, termed the low-profit limited liability company (L3C). The Oregon bill remained in the Business and Labor Committee upon adjournment of the 2011 session; thus, the L3C form will not be entering the Oregon business landscape just yet.²

However, as more and more states are adopting L3C legislation, it will be no surprise if L3C legislation is reintroduced in Oregon's next legislative session.³ Oregon is home to a relatively high number of nonprofit organizations per capita; thus, the state will likely see sustained interest in L3Cs that, like nonprofit organizations, also further charitable purposes.⁴ As Oregon and other states continue to consider such legislation, the time is ripe to assess the benefits and drawbacks of the L3C. An effective analysis of the L3C is incomplete without looking at the promises of the L3C form as well as its ability to meet those promises. This Comment will assess the form's promises in the context of private foundations, other investors, and allegiance to charitable purpose.

The L3C has emerged in an era of change for funding of mission-driven work. On one hand, the current economic recession has resulted in reduced giving to tax-exempt, charitable nonprofit organizations, key traditional actors in the mission-driven field. In fact, giving to these organizations fell by eleven percent from 2007 to 2011.⁵ On the other hand, interest in socially responsible investing is on the rise: from 2007 to 2010, socially responsible investing grew at a rate of thirteen percent.⁶ The increasing interest in socially

¹ H.B. 2745, 76th Legis. Assemb., Reg. Sess. (Or. 2011).

² H.B. 2745, 76th Legis. Assemb., Reg. Sess. (Or. 2011), Full Measure History, available at www.leg.state.or.us/11reg/pubs/hsemh.html.

³ *Infra* note 10.

⁴ See *Number of Registered Nonprofit Organizations by State, 2008*, NAT'L CTR. FOR CHARITABLE STATISTICS, <http://nccsdataweb.urban.org/PubApps/reports.php?rid=2> (last visited July 26, 2012).

⁵ *Giving Statistics*, CHARITY NAVIGATOR, <http://www.charitynavigator.org/index.cfm?bay=content.view&cpid=42> (last visited July 18, 2012).

⁶ *Sustainable and Responsible Investing Facts*, US SIF, <http://ussif.org/resources/sriguide/srifacts.cfm> (last visited July 18, 2012). Socially responsible investing is a broad

responsible investing parallels the L3C's rise for good reason. By statute, the L3C can distribute profits but must also prioritize a charitable purpose, making it a particularly apt vehicle for an investor concerned with the ultimate impact of her dollar.

However, the L3C cannot be understood solely in the context of mission-driven work. This new iteration of the LLC also emerged as one step in a broader effort to facilitate foundation investing through a mechanism called program related investments (PRIs).⁷ The potential of the L3C form lies in its capacity to leverage foundation funding with investments from socially conscious investors interested in accepting a lower rate return in exchange for an investment that furthers a certain cause, as well as market rate investors seeking standard rates of return.⁸ Through this tranching investment model, where different classes of investors accept different rates of return, the L3C could serve as a new kind of vehicle for mission-driven and charity work.

Much of the current L3C scholarship and analyses focus on whether the form is a superior vehicle for PRIs by private foundations. This Comment looks at the L3C in the foundation investment context but also in the context of other private investors. Further, this Comment assesses the L3C form's current ability to ensure enforcement of the primary priority of charitable purpose. While it is not the only piece of the puzzle, the enforcement of charitable priority is a critical aspect of the L3C's ability to serve as a successful vehicle of impactful mission-driven and charitable work.

Part I provides an introduction to the L3C through a discussion of the form's potential and "promises" in three contexts: tax and private foundation investment, other private investment, and the broader promise of a new approach to mission-driven work. Part II examines the shortfalls of the L3C in these three contexts. In particular, Part II demonstrates that the current approach to the L3C form lacks tools to hold L3Cs accountable to the priority of charitable purpose. Part III explores a few ideas toward a more comprehensive approach to oversight, including a mandatory information return and specific

concept that generally encompasses investor concern for the societal impact of an investment; it does not consist solely of investments in entities performing mission-driven work. Socially responsible investing is also referred to as mission investing, triple bottom line investing, or ethical investing. *Id.*

⁷ See *infra* Part I.A.

⁸ See *infra* Part I.B.

authority in an oversight figure or body. Ultimately, the viability of the L3C depends on the ability of scholars, practitioners, and legislators to see the form as a work in progress. Thorough analysis and bold creativity can contribute to the L3C's impact as a form of business and as a vehicle for impactful, inspiring work.

I

AN INTRODUCTION TO THE FORM: THE PROMISE OF THE L3C

In 2008, Vermont became the first state to adopt legislation enabling the creation of an L3C entity.⁹ Following Vermont, eight other states have adopted similar legislation, and several others have or are considering similar legislation.¹⁰ Understanding the relatively fast rise and continuing momentum of this new entity requires a look at realities in the tax, investment, and mission-driven contexts. In each of these distinct contexts, the L3C promises to fill a particular niche.

A. The Tax Promise of the L3C

The best way to unpack the theory behind the L3C is to understand the PRI, a tax exception that allows private foundations to make investments that further their charitable purpose even if those investments might otherwise be considered too financially risky.¹¹ A few key tax statutes and regulations governing private foundations shed light on the PRI.

The Internal Revenue Code (IRC) requires private foundations to meet certain minimum distribution requirements. A private foundation must distribute at least five percent of its assets annually.¹² Only “qualifying distributions” count toward this minimum. A qualifying distribution is an amount paid to accomplish one of the purposes listed in IRC section 170(c)(2)(B): “religious, charitable,

⁹ VT. STAT. ANN. tit. 11, § 3001 (West, Westlaw through 2011-2012 adjourned sess.).

¹⁰ In addition to Vermont, these states have adopted L3C legislation: Illinois, Louisiana, Maine, Michigan, North Carolina, Rhode Island, Utah, and Wyoming. Additionally, at least sixteen other states are considering or have considered L3C legislation, including: Alabama, Arkansas, Arizona, California, Colorado, Georgia, Hawaii, Indiana, Iowa, Kentucky, Maryland, Massachusetts, Montana, New York, Oklahoma, and Oregon. J. Haskell Murray & Edward I. Hwang, *Purpose with Profit: Governance, Enforcement, Capital-Raising and Capital-Locking in Low-Profit Limited Liability Companies*, 66 U. MIAMI L. REV. 1, 4 nn.12–13 (2011).

¹¹ See I.R.C. § 4944(c) (2006).

¹² *Id.* § 4942(d)–(e).

scientific, literary, or educational purposes, or to foster national or individual amateur sports competition . . . or for the prevention of cruelty to children or animals.”¹³ In other words, a distribution, such as a grant, made for one of the section 170(c)(2)(B) purposes, can be a qualifying distribution. A distribution, such as an investment made for the production of income, is not a qualifying distribution.

In addition to the annual minimum distribution requirement, the IRC also establishes standards to deter a private foundation from making risky investments. In order to avoid penalty taxes, a private foundation must not invest any amount in a manner that jeopardizes the carrying out of any of its exempt purposes.¹⁴ An investment will be deemed a “jeopardy investment” if it is determined that the investment threatens “the long- and short-term financial needs of the foundation to carry out its exempt purposes.”¹⁵ In other words, jeopardy investments are investments that are unduly risky.¹⁶ A jeopardy investment subjects the investing foundation, as well as any foundation manager who participated in making the investment, to excise taxes.¹⁷

At the cross-section of these two regulations lies an exception: the PRI.¹⁸ If a private foundation makes an investment for the primary purpose of accomplishing a charitable purpose, then per IRC section 170(c)(2)(B), that investment will not be considered a jeopardizing investment, even if it is financially risky.¹⁹ Moreover, such an investment will count toward the foundation’s annual minimum distribution requirement.²⁰ In other words, the PRI exception is potentially very useful for a private foundation. It aids the foundation in meeting its annual minimum distribution, and it allows the foundation to invest in the accomplishment of its charitable purpose in a manner that might otherwise be considered too financially uncertain.²¹

¹³ *Id.* § 4942(g)(1)(A).

¹⁴ *Id.* § 4944(a)(1).

¹⁵ Treas. Reg. § 53.4944-1(a)(2)(i) (as amended in 1973).

¹⁶ Carter G. Bishop, *The Low-Profit LLC (L3C): Program Related Investment by Proxy or Perversion?* 63 ARK. L. REV. 243, 255 (2010).

¹⁷ I.R.C. § 4944(a)(1)-(2).

¹⁸ *Id.* § 4944(c).

¹⁹ *See id.*

²⁰ *See id.* § 4942(g)(1)(A).

²¹ PRIs often include loans, loan guarantees, equity investments in charitable organizations, or commercial ventures for charitable purposes. Robert Lang & Elizabeth

However, the question of whether an investment is a PRI is not simple. The first part of this inquiry requires that the investment meet certain definitional elements. The primary purpose of the investment must be to accomplish one or more of the objectives described in section 170(c)(2)(B), such as a religious, charitable, or scientific purpose. The investment cannot have the significant purposes of production of income, appreciation of property, or accomplishment of one or more of the purposes described in section 170(c)(2)(D), such as attempting to influence legislation.²² While these definitional elements seem relatively straightforward, the second part of the inquiry is much more nuanced. An investment will only meet the first definitional element—that the investment must be made to accomplish one or more of the religious, charitable, scientific, or other section 170(c)(2)(B) purposes—“if it significantly furthers the accomplishment of the private foundation’s exempt activities and if the investment would not have been made but for such relationship between the investment and the accomplishment of the foundation’s exempt activities.”²³

Due to this strict inquiry, the burden on a private foundation wishing to make a PRI is relatively high. For each PRI, a foundation must consider its own mission, the mission of the recipient organization, the relationship between the two missions, and whether the governance and financial structure of the recipient organization is such that it will operate within the PRI definition.²⁴ A private foundation’s failure to carefully undertake these considerations could result in an investment being characterized as a jeopardy investment rather than a PRI, thus subjecting the foundation and any participating foundation managers to the “toxic” tax penalties associated with jeopardy investments.²⁵ As a result, when a private foundation wishes to make a PRI, prudence requires, at a minimum, an advice letter

Carrott Minnigh, *The L³C, History, Basic Construct, and Legal Framework*, 35 VT. L. REV. 15, 16 (2010).

²² Treas. Reg. § 53.4944-3(a)(1)(i)–(iii) (1972). The purposes described in IRC section 170(c)(2)(B) are “religious, charitable, scientific, literary, or educational purposes, or to foster national or individual amateur sports competition . . . or for the prevention of cruelty to children or animals.” IRC section 170(c)(2)(D) describes purposes of attempting to influence legislation or participating or intervening in any political campaign on behalf of any candidate for public office.

²³ Treas. Reg. § 53.4944-3(a)(2)(i) (1972).

²⁴ Daniel S. Kleinberger, *A Myth Deconstructed: The “Emperor’s New Clothes” on the Low-Profit Limited Liability Company*, 35 DEL. J. CORP. L. 879, 891 (2010).

²⁵ Bishop, *supra* note 16, at 244–46, 252–53.

from counsel.²⁶ However, an advice letter does not guarantee that the Internal Revenue Service will not reach a contrary conclusion and deem the investment to be a jeopardy investment. The only way to guarantee that an investment will fall within the PRI exception is to obtain a private letter ruling from the IRS, a process that is time-consuming and expensive.²⁷ As a result, many in the foundation community envisioned an approach to PRIs that lacked the burdensome process, and thus, encouraged more foundations to invest.

The developers of the L3C concept sought to encourage more foundations to make PRIs by eliminating this investment-by-investment inquiry, with the L3C form as a sort of pre-approved PRI recipient. To do so, the drafters of L3C state legislation modeled L3C statutes after the regulations that define PRIs, such that a foundation could make an investment in an L3C and assume that such an investment would be a PRI.²⁸ The critical definitional requirements of the L3C parrot the same three elements as the PRI exception: (1) the company must significantly further the accomplishment of a charitable or other IRC section 170(c)(2)(B) purpose and would not have been formed but for that purpose; (2) no significant purpose of the company is the production of income or the appreciation of property; and (3) no purpose of the company is to accomplish one or more political or legislative purposes under section 170(c)(2)(D).²⁹ The matching language is only the first step: L3C proponents have advocated for legislation to “simplify the [PRI] approval process at the IRS level.”³⁰ The aim of this legislation is alleviating foundations’

²⁶ *Id.* at 258.

²⁷ *See id.* at 259.

²⁸ Robert Lang, one of the main individuals involved in developing the L3C concept, has stated that the intent behind the form’s design was to take advantage of PRIs. Robert M. Lang, Jr., *The L3C: The New Way to Organize Socially Responsible and Mission Driven Organizations*, in TAX EXEMPT CHARITABLE ORGANIZATIONS 251, 254 (Am. Law Inst. & Am. Bar Ass’n eds., 2007), available at Westlaw SN036 ALI-ABA 251; *see also* John Tyler, *Negating the Legal Problem of Having “Two Masters”: A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117, 122 (2010) (“Part of the impetus for the L3C was the unrealized potential of PRIs, the misperception that only sophisticated foundations could deploy PRIs, and frustration with the time and expense of pursuing pre-approval of PRIs from the IRS—even though such pre-approval is not legally required as a condition of making a PRI.”).

²⁹ *See, e.g.*, VT. STAT. ANN. tit. 11, § 3001 (West, Westlaw through 2011–2012 adjourned sess.).

³⁰ Lang & Carrot Minnigh, *supra* note 21, at 22.

hesitation to make PRIs by replacing the investment-by-investment inquiry with a “road map” that gives foundations “a chance to get a blessing by the IRS on the investment in a shorter period of time with less cost.”³¹ Specifically, L3C proponents have advocated for a rebuttable presumption that investments made in L3Cs will be considered PRIs.³² However, this legislation has not yet passed, and commentary from members of the Senate Finance Committee does not suggest a promising outlook: the Committee noted, “[w]e have not had any hearings on this particular matter and do not think that it is ripe for federal legislation.”³³ At this point, this legislation, a critical component of the quest to make PRIs more accessible, seems like a long shot.

B. The Investment Promise of the L3C

An L3C’s ability to facilitate investment from private foundations through PRIs is only part of the equation. Another essential part of the equation is an L3C’s ability to attract private investments from individuals, including those motivated by charitable purpose and those seeking a market-rate return. In many ways, foundation investments and investments from individuals are mutually dependent: according to Professor Daniel Kleinberger, “an L3C exists to (i) receive foundation money through the PRI mechanism and then (ii) leverage that money with investments from for-profit private investors.”³⁴ Of course, all investors are likely to come to an L3C with different motives and interests. Balancing those varying interests requires an investment model that provides adequate protections to each type of investor.

Foundations seeking to make a PRI in an L3C will be concerned with the prioritization of charitable purpose. But when an L3C prioritizes charitable purpose, the organization is not likely to yield market-level returns. To facilitate a functional investment structure, L3C proponents have suggested tranching, where “investments are layered vested member ownership interests within the L³C.”³⁵ While

³¹ *Id.* at 23.

³² *See id.*

³³ G. Ann Baker, *Did You Know?*, 29 MICH. BUS. L.J. 5, 6 (2009), available at <http://www.michbar.org/business/BLJ/Summer%202009/baker.pdf> (quoting the Senate Finance Committee).

³⁴ Kleinberger, *supra* note 24, at 884.

³⁵ Cody Vitello, Comment, *Introducing the Low-Profit Limited Liability Company (L³C): The New Kid on the Block*, 23 LOY. CONSUMER L. REV. 565, 571 (2011).

L3C members can structure tranches as they wish, the L3C model is commonly discussed with three tranches: an equity tranche, a mezzanine tranche, and a senior tranche.³⁶ In the equity tranche, private foundations make high-risk, low-return investments, most likely in the form of PRIs. In the mezzanine tranche, socially conscious investors carry a moderate amount of risk with moderate returns. In the senior tranche, market-driven investors carry the least risk and have the greatest return.³⁷ In other words, when the rate of return is markedly lower, the investments of the equity tranche subsidize the senior tranche's higher returns.

The appeal of the properly-functioning L3C has attracted foundation investors to the equity tranche because their investments would be deemed PRIs. Socially conscious investors are attracted to the mezzanine tranche due to a promise of moderate return and the ability to fund a charitable project. Market investors are attracted to the senior tranche due to its consistent rate of return. The end result, in a perfect world, is an infusion of new capital for charitable purposes, investors whose interests and motivations are met through a funded charitable impact, and a particular rate of return.

C. The Broader Promise of the L3C: Funding Mission-Driven Work

The L3C's escalating rise demonstrates that the PRI connection and the tranced investment model are only part of the story. Proponents view the form more broadly as a new approach to funding mission-driven and charitable purposes. Scholars and proponents have presented numerous perspectives on how the L3C fits in the bigger picture of mission-driven work in relation to traditional nonprofit organizations.

A recent student comment suggests that L3Cs are a viable alternative to complex joint ventures between a nonprofit organization and a for-profit business, which are "often too complex to organize and manage effectively."³⁸ Due to the complexity of these ventures, one consistent challenge is clear outside recognition;³⁹ essentially, this kind of joint venture lacks a recognizable brand. Thus, the L3C form serves as a branded, recognizable alternative between nonprofit

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.* at 568.

³⁹ *Id.*

organizations that face funding challenges and for-profit companies that must consistently earn a certain rate of return to attract investors.⁴⁰

Professor Linda Smiddy has placed greater emphasis on the public view of the strictly nonprofit and for-profit forms, arguing that a hybrid form such as an L3C may be able to avoid the pitfalls of both. The economic downturn has yielded a public dissatisfaction with the for-profit sector's failure to focus on social responsibility. At the same time, economic challenges drive home the reality that nonprofit organizations cannot depend solely on charitable giving for sustainable funding.⁴¹ Thus, a hybrid form like the L3C serves as an alternative to the traditional nonprofit by allowing for-profit models of raising capital.⁴² As a result, Smiddy argues, social enterprises can attract investors seeking a return on their investment, but who are willing to accept a lower-than-market return rate due to their interest in furthering the company's social mission.⁴³

These characterizations of the L3C form are marked by the view that the form fills a void *between* traditional for-profit and nonprofit forms. However, Robert Lang, a founder of the L3C movement and one of the form's most zealous advocates, has implied that the L3C form should actually replace the traditional nonprofit in some circumstances. Lang suggests that the L3C "provides a vehicle for eliminating many nonprofits which are problematic and should reduce the proliferation of nonprofits."⁴⁴ At the same time, Lang argues, the L3C "provides for better utilization of foundation and trust funds and gives them a reasonable control of how their money is used after it leaves their hands."⁴⁵ Lang's comments suggest that, in his view, there are too many nonprofits and that nonprofits do not allow for sufficient input and control from their funders, including foundations.

In essence, then, the L3C could conceivably fit between the traditional for-profit and nonprofit forms or potentially serve as a replacement or alternative to the nonprofit form. Regardless of where the L3C most appropriately sits, its potential role centers on increasing funding for mission-driven work. The question is whether

⁴⁰ *Id.* at 566–67.

⁴¹ Linda O. Smiddy, *Corporate Creativity: The Vermont L3C & Other Developments in Social Entrepreneurship*, 35 VT. L. REV. 3, 4 (2010).

⁴² *Id.*

⁴³ *Id.* at 9.

⁴⁴ Lang, *supra* note 28, at 257.

⁴⁵ *Id.*

that funding is more likely to come from investors interested in returns and a social mission, or from foundations interested in doing more investing and possibly less granting. After all, private investors and foundations have different expectations associated with their investment.

II

WHERE THE L3C FALLS SHORT

In spite of the promise and momentum behind the L3C movement, the form suffers from several shortcomings that detract from its potential. First, without explicit changes to the IRC, the L3C form does not replace the burdensome investment-by-investment inquiry required for PRIs, and thus, there is no tax advantage to a foundation making a PRI in an L3C over any other type of entity. Second, there is a significant lack of clarity around the functional utility of the tranced investment structure in the L3C context. Third, there is no viable mechanism in place for enforcing the priority of the charitable purpose in L3Cs. These shortcomings merit attention not solely for the sake of criticism, but because they can help guide the L3C conversation and lead to greater efficacy in the L3C form and its various enabling statutes.

A. No Tax Advantage

Perhaps the single most important motivating factor behind the development of the L3C form was facilitating an efficient route for private foundations to make more PRIs.⁴⁶ However, without any change to federal tax law validating a privileged relationship between L3Cs and PRIs, the PRI process for an investment in an L3C is the same as the process for a PRI investment in any other entity. Professor Carter Bishop has given extensive treatment to that relationship, positing that “the ultimate utility of the [L3C] form uniquely depends on the resolution of the federal tax question.”⁴⁷ At the time of Bishop’s research, as well as today, “there is no federal tax authority indicating that PRI determination will be satisfied merely by the L3C operation restrictions.”⁴⁸ As a result, “there is no

⁴⁶ See, e.g., Lang, *supra* note 28, at 254 (“The key to the L3C is that it was specifically designed to take advantage of the [PRI].”).

⁴⁷ Bishop, *supra* note 16, at 245.

⁴⁸ *Id.* at 250.

reason to suppose that a private-foundation investment in an L3C will automatically qualify for PRI status any more than any other investment in any other entity.”⁴⁹ The fact that the rise of the L3C form has not been accompanied by a change in federal tax law has two important implications.

First, while an investment in an L3C certainly *may* qualify as a PRI, the PRI determination still boils down to an investment-by-investment inquiry. Because this inquiry is still needed, Bishop argues, “private-foundation managers must exercise the same care in investing in an L3C as in any other LLC or entity, which requires either an opinion of counsel or a private letter ruling.”⁵⁰ Professor Daniel Kleinberger has argued that because the case-by-case inquiry is an essential component of a PRI, the proposed federal tax changes would fail to address this reality. Included in proposed federal tax changes is a rebuttable presumption of PRI status for investment entities, such as L3Cs, approved through “safe-harbor” determinations.⁵¹ Kleinberger states: “the rebuttable presumption ignores the core of PRI analysis—i.e., the suitability of the investment vehicle, judged in terms of the particular purpose of the investing foundation, and the particular purpose and structure of the investment vehicle.”⁵² Kleinberger’s point may explain the hesitancy expressed by some academics and at least one legislator to codify the rebuttable presumption in new legislation.⁵³

Second, in addition to the specific inquiry still required for PRIs, some critics have pointed to another issue: the danger of L3C branding in spite of the lack of federal tax blessing of the form. Kleinberger opines that the presumed but unfounded link between L3Cs and PRIs makes the L3C construct to be “unnecessary, unwise, and inherently misleading.”⁵⁴ The danger of branding in the context of a legal entity is that the form may give rise “to the delusion that the form actually does something, and ill-advised people may use it

⁴⁹ *Id.*

⁵⁰ *Id.* at 267.

⁵¹ H.R. 3420, 112th Cong. (2011); see also *Proposed Federal Legislation*, AMS. FOR CMTY. DEV. (Nov. 15, 2011), <http://www.americansforcommunitydevelopment.org/proposedfedlegislation.html>.

⁵² Kleinberger, *supra* note 24, at 907.

⁵³ See David S. Chernoff, *L3Cs: Less than Meets the Eye*, 22 TAX’N OF EXEMPTS 3, 3–4 (2010); see also Baker, *supra* note 33.

⁵⁴ Kleinberger, *supra* note 24, at 896.

believing that the form enables PRI treatment.”⁵⁵ In addition to PRI determinations, Kleinberger points to an array of issues that could potentially result from a misleading L3C brand, including “conflicts of fiduciary duty for the foundation trustees, securities law concerns, and ‘exit rights’ for the foundation.”⁵⁶ In light of these concerns, Kleinberger considers the brand “simplistic and dangerous.”⁵⁷

Whether the mere presence of the L3C form is as harmful as some critics have claimed remains to be seen, but one conclusion is certain: a foundation investment in an L3C is no different than a foundation investment in an LLC or any other entity, and such an investment requires all of the careful analysis and due diligence to prevent a jeopardy investment and the excise tax that follows. Suffice it to say that, at this point, the L3C form adds no value in the foundation context.

B. No Structural Clarity

The tranching investment model is commonly discussed as a strong possibility for L3C financing.⁵⁸ However, using the tranching model in the L3C context conjures more questions than answers. The tranching model requires investments with varying expected rates of return.⁵⁹ One critical issue, then, is the feasibility of attracting investors at each tranche level. Professor Dana Brakman Reiser points out that the success of this model depends on “how large a slice of the investing public will be interested in a below-market financial return combined with the psychic value of investing in an entity pursuing a blended mission.”⁶⁰ Any returns for these below-market investors and market-rate returns for the higher tranche investors are predicated on private foundations’ willingness to “accept grant-like, near-zero-rate returns.”⁶¹ Even if an L3C can attract investments for the below-market investor tranche and the foundation tranche, attracting the market-rate investors presents a different set of challenges.

⁵⁵ J. William Callison & Allan W. Vestal, *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures*, 35 VT. L. REV. 273, 291 (2010).

⁵⁶ Kleinberger, *supra* note 24, at 898.

⁵⁷ *Id.*

⁵⁸ See, e.g., Vitello, *supra* note 35, at 571.

⁵⁹ See *id.*

⁶⁰ Dana Brakman Reiser, *Governing and Financing Blended Enterprise*, 85 CHI.-KENT. L. REV. 619, 647 (2010).

⁶¹ Murray & Hwang, *supra* note 10, at 22.

Most critically, market-rate investors may be wary of the L3C statutory prohibition on prioritizing profit. Reiser notes, “a tranching membership L3C must find a way to assure its targeted market-rate investors that their promised returns will be achieved when the entity is not being managed toward an ultimate profit goal.”⁶² Kleinberger is also skeptical about this feasibility, wondering “[h]ow is it possible to have a low *profit* limited liability company when *no significant purpose of the company is the production of income or the appreciation of property?*”⁶³ In a stronger economic environment, an L3C might be able to convince its market-rate investors to overlook its statutory constraints on profit and its “low-profit” title. However, those points raise legitimate questions about an L3C’s initial ability to attract investors.

Beyond the feasibility of the tranching investment model, some critics have raised questions about the propriety and even legality of subsidizing market-rate investment returns with below-market and foundation investments. Professors Murray and Hwang posit that below-market rate investors and the IRS will not look favorably on the tranching model, and that below-market rate investors “will be less likely to invest if it becomes evident that their funds are simply going to provide market-rate profits for traditional investors.”⁶⁴ In the context of foundation investments, Bishop has also expressed concern, noting that the model “potentially violates the private-inurement restriction” and “raises the specter of impropriety regarding whether the foundation is allowing its assets to be used to inure private benefit to the commercial or market tranche in the L3C.”⁶⁵ The private-inurement restriction stems from a private foundation’s exemption from federal income tax. As a condition to this exemption, no part of a private foundation’s net earnings may inure to the benefit of any private shareholder or individual.⁶⁶ As Bishop explains, where a tax-exempt organization undercharges for the use of its assets, inurement can occur.⁶⁷ Thus, a private foundation could potentially violate the private-inurement restriction if the foundation investment

⁶² Brakman Reiser, *supra* note 60, at 648.

⁶³ Kleinberger, *supra* note 24, at 909 (emphasis in original).

⁶⁴ Murray & Hwang, *supra* note 10, at 50.

⁶⁵ Bishop, *supra* note 16, at 265.

⁶⁶ I.R.C. § 501(c) (2006); *see also* Treas. Reg. § 1.501(c)(3)-1(c)(2) (as amended in 2008).

⁶⁷ Bishop, *supra* note 16, at 265.

tranche is undercharging for the use of its capital.⁶⁸ While most concerns about the tranching model are tied more closely to financing feasibility than to legality, these issues do hint at a significant shortfall of the L3C form: the lack of enforcement mechanisms to ensure charitable priority.

C. No Viable Mechanism for Enforcing Charitable Priority

Perhaps the most challenging question about the L3C form still left unanswered is that of the enforceability of an L3C's charitable priority. This question presents a relatively new and unfamiliar issue because the only other entities that prioritize charitable purposes tend to be tax-exempt, charitable nonprofit corporations. Because charitable nonprofit corporations hold assets dedicated to charitable purposes, they are subject to oversight, usually by the Attorney General.⁶⁹ The Official Comments to the Model Protection of Charitable Assets Act provide a relevant description of the nature of this oversight:

The Attorney General's duty has sometimes been described as the "parens patriae" power—the duty to protect the public interest in property that has been committed to charitable purposes. Unlike a private corporation or a private trust, no shareholder or private beneficiary has a financial incentive to supervise the proper management of the assets held for charitable purposes . . . under the common law only the Attorney General has standing to sue or take action to protect the public's interest in charitable assets.⁷⁰

Like a charitable nonprofit corporation, an L3C operates for charitable purposes; however, an L3C does not operate *exclusively* for charitable purposes. While an L3C can legally pursue non-charitable purposes, it must always prioritize charity.⁷¹ Private foundations and

⁶⁸ *Id.*

⁶⁹ See, e.g., MASS. GEN. LAWS ANN. ch. 12 § 8 (West, Westlaw through 2012 ch. 141).

⁷⁰ MODEL PROT. OF CHARITABLE ASSETS ACT § 3, cmt. (2011).

⁷¹ Due to the L3C form's aspired links to PRIs, current L3C enabling statutes clearly articulate the mandated order of priorities. John Tyler, General Counsel for the Ewing Marion Kauffman Foundation, states that L3C statutory schemes are so clear as to leave no question as to the priority of purposes. Tyler considers the L3C fiduciary priorities to be "unambiguous" and finds these priorities to "[exalt] charitable purpose above all other purposes." Tyler, *supra* note 28, at 141. Further, profit-related purposes belong "not just secondary on the continuum of permissible purposes, but near the extreme end of such continuum. *Id.* Tyler correctly points out the clear articulation of priority in L3C statutes. Identifying the priority, in reality, is not the challenge. Rather, the challenge lies in the

socially conscious investors will choose to invest in an L3C because of that organization's dedication to particular charitable work. Private foundations will do so through the PRI mechanism. Socially conscious investors' motivation to accept lower than market-rate returns is premised on their interest in seeing the charitable purpose carried out. In effect, then, L3Cs hold charitable assets of a kind: foundation and socially conscious investments are inextricably linked with an L3C's charitable purpose.

However, L3Cs may pursue other purposes, unlike charitable, nonprofit organizations. The critical issue then is identifying the proper and effective enforcement mechanism for L3Cs, which are not obligated to pursue solely charitable purposes. Scholars and practitioners have pointed to a number of potential mechanisms already in place that are aimed to ensure charitable primacy: the conversion of L3C status to LLC upon deviation from charitable primacy; the ability to provide enhanced voting power to the foundation tranche; and the utility of numerous traditional for-profit enforcement tools. Unfortunately, each of those mechanisms fails to produce a viable approach that safeguards charitable priority in L3Cs.

1. Dissolution or Conversion of L3C Status

As different states enact L3C legislation, legislators have taken a variety of approaches to the issue of prioritizing charitable purpose. Michigan and Wyoming each provide statutory authority for the loss of L3C status if an organization ceases to meet the L3C definitional requirements.⁷² In Michigan, the Attorney General is authorized to initiate an action if an L3C fails to meet the definitional requirements, including prioritizing charitable purpose.⁷³ If the Attorney General finds that an organization is not fulfilling its stated charitable purpose, she has the authority to dissolve the organization completely.⁷⁴ Wyoming enacted similar legislation but places the oversight authority with the Secretary of State.⁷⁵ If an L3C is not in compliance with the definitional requirements, the Secretary of State mails a notice and unless compliance is made within 60 days, the

"[m]ore problematic . . . related matter of identifying processes and systems for ensuring accountability for faithfulness to that order." *Id.* at 143.

⁷² MICH. COMP. LAWS ANN. § 450.4803 (West, Westlaw through P.A. 2012, no. 297); WYO. STAT. ANN. § 17-29-705(e) (West, Westlaw through 2012 budget sess.).

⁷³ MICH. COMP. LAWS ANN. § 450.4803(1) (West 2012).

⁷⁴ *Id.*

⁷⁵ WYO. STAT. ANN. § 17-29-705 (West, Westlaw through 2012 budget sess.).

organization is deemed defunct.⁷⁶ Thus, Michigan and Wyoming L3Cs are subject to government oversight and can be dissolved for failing to prioritize charitable purpose.

Rhode Island's L3C statutes do not explicitly grant oversight authority to a government body, but do suggest that the loss of L3C status is a possibility. In Rhode Island, an L3C that fails to meet the definitional requirements immediately ceases to be an L3C but continues to exist as an LLC and must change its name accordingly.⁷⁷ As such, Rhode Island's statutes prompt the question: who has the authority to decide whether a Rhode Island L3C is operating in accordance with the definitional requirements?

Moreover, the statutes in Michigan, Wyoming, and Rhode Island provide no guidance as to *how* an L3C's adherence to the definitional elements, and thus, charitable purpose, can be regulated or gauged. Other state statutes that call for a similar outcome of judicial dissolution of an entity are triggered by events such as the failure to file an annual report.⁷⁸ This type of event is easy to identify: either an organization files an annual report or it fails to file a report. Conversely, an L3C's failure to meet the state definitional requirement of prioritizing charitable purpose is significantly more difficult to identify without metrics, guidelines, or processes. As Murray and Hwang note: "The mechanism and enforcement of a forced conversion from an L3C immediately to a LLC is unclear and potentially problematic."⁷⁹ Indeed, these "forced conversion" provisions seem rather toothless without an enforcement scheme. Further, what of the socially minded investors who invested in a particular entity in support of its "low-profit" brand and the priority of its charitable purpose?⁸⁰ Because they lack an enforcement mechanism or a process for ensuring that charitably motivated investments will be honored or returned to the investor, the "forced conversion" provisions fall short of providing adequate assurance of charitable primacy.

⁷⁶ WYO. STAT. ANN. § 17-29-705(a) (West, Westlaw through 2012 budget sess.).

⁷⁷ R.I. GEN. LAWS ANN. § 7-16-76(c) (West, Westlaw through 2012 ch. 109).

⁷⁸ See, e.g., OR. REV. STAT. § 63.787 (2011).

⁷⁹ Murray & Hwang, *supra* note 10, at 31 n.164.

⁸⁰ Murray and Hwang also raised this question, advocating that "[u]pon conversion to or purchase by a profit-focused entity, the law should require the L3C to cash out the socially minded investors." *Id.* at 51.

2. *More Voting Power for Foundation Tranche*

Of all types of investors in an L3C, foundation investors have the strongest motives to hold an organization accountable to prioritizing charity.⁸¹ Professor Brakman Reiser proposes one approach where foundation investors would hold significant voting power in “matters of management or policy” and “other rights that would vest significant control over the L3C’s operations.”⁸² Under this approach, non-foundation investors would see a “corresponding reduction or exclusion of governance rights.”⁸³ While it may be proper to endow this kind of control to foundation investors rather than to investors more concerned with profit, this approach raises at least two critical questions.

There are several reasons to suggest that enforcement by the foundation tranche is not an adequate check on charitable priority. First, foundations may not be equipped or ready to engage in this level of involvement with an L3C: after all, if the foundation tranche has little or no expectation or interest in profits, it may not be motivated to apply a great deal of “rigor and efficiency” to enforcing charitable priority.⁸⁴ Second, another concern returns to the issue of financing: market rate investors and even below-market rate investors are likely to be particularly wary of investing in an organization where they have no or limited voting rights.⁸⁵ Without investment at each tranche level, including the market rate tranche, the model cannot function. Thus, relying on enforcement by the foundation tranche is simply not feasible as a sole approach to ensuring charitable priority in L3Cs across the board.

3. *For-Profit Enforcement Tools*

John Tyler has concluded that the multiple characteristics differentiating the L3C from charitable, exempt organizations tip the scale away from charitable enforcement mechanisms, vested in oversight authorities, and toward for-profit enforcement tools, generally vested in individuals.⁸⁶ His position is premised on four

⁸¹ Brakman Reiser, *supra* note 60, at 628–29.

⁸² *Id.* at 628.

⁸³ *Id.* at 628–29.

⁸⁴ Brakman Reiser, *supra* note 60, at 651.

⁸⁵ See Dana Brakman Reiser, *Blended Enterprise and the Dual Mission Dilemma*, 35 VT. L. REV. 105, 111 (2010).

⁸⁶ See Tyler, *supra* note 28, at 154. Tyler suggests three for-profit enforcement tools to ensure an L3C’s accountability to prioritizing charitable purpose: criminal and civil claims

distinctions between L3Cs and charitable, exempt organizations.⁸⁷ First, L3Cs can earn and distribute profits, seeking profit as a lesser purpose than the primary charitable purpose.⁸⁸ Second, Tyler urges against perceiving L3C investors as lacking an “investor mindset”: L3C investors may anticipate below market returns, but will not invest funds “for the managers to use at their pleasure without regard to accountability.”⁸⁹ Third, as L3C distributions and appreciation are taxable, “the government’s interest in enforceability is not driven by accounting for favorable, charity-based tax policy.”⁹⁰ Fourth, because L3Cs can distribute profits, Tyler argues that they should be “fully submerged in the market economy and operate subject to its forces.”⁹¹

However, Tyler’s argument fails to acknowledge certain realities about the L3C form that necessitate more, rather than the same, types of oversight as other for-profit forms. The pursuit of a charitable purpose and the pursuit of a profit-earning purpose are likely to conflict; in a decision-making context, the choice to do the most good will rarely be the choice that also yields the greatest returns. It is precisely this unique attribute of the L3C—the priority of charitable purpose coupled with the ability to pursue profit—that begs for metrics to guide decision-making and organizational analysis. Metrics are essential for socially conscious investors to assess potential investment decisions and for attorneys general and secretaries of state to know when to force dissolution of an L3C or the conversion of an L3C to an LLC.⁹²

for fraud and misrepresentation; vesting authority in the Attorney General to pursue members or managers for ultra vires act if they fail to properly prioritize charitable purposes; and piercing the veil of limited liability for deviation from ordered priorities. *Id.* at 156–57.

⁸⁷ *Id.* at 151.

⁸⁸ *Id.*

⁸⁹ *Id.* at 151–52.

⁹⁰ *Id.*

⁹¹ *Id.* at 152–53.

⁹² Such dissolution or conversion would only apply in states such as Michigan, Wyoming, and Rhode Island where statutory provisions create this possibility. *See* MICH. COMP. LAWS ANN. § 450.4803 (West, Westlaw through P.A. 2012, no. 297); R.I. GEN. LAWS § 7-16-76 (West, Westlaw through 2012 ch. 109); WYO. STAT. ANN. § 17-29-705(e) (West, Westlaw through 2012 budget sess.).

III

POSSIBILITIES FOR AN IMPROVED APPROACH TO ENFORCEMENT

Due to the deficiencies in the current approaches to enforcement of the L3C charitable priority, the default statutory rules leave the blended mission of the L3C—priority of charitable purpose with profit allowed as a less important purpose—“essentially unprotected.”⁹³ In light of this significant deficiency, and the fact that the L3C does nothing an LLC cannot accomplish, the L3C form may not be truly necessary. However, if the Oregon legislature or legislatures in other states choose to consider L3C legislation, it is essential that L3C enabling statutes include a proactive approach to the enforcement of charitable priority. Moreover, a clear enforcement mechanism would contribute positively to the L3C brand, “[improving] the L3C’s claim to a position as a home for blended enterprise.”⁹⁴ The most effective approach to viable enforcement involves several tools. The first critical step to creating the basis for effective enforcement is mandating a publicly filed information return. The second critical step is naming an oversight authority, as exemplified by the statutory approaches in Michigan and Wyoming.

A. The Limited Liability Company

No discussion of improvements to the L3C form is complete without an honest inquiry about whether the form is, in fact, necessary at all. Professors Bishop and Kleinberger, among academia’s more vocal skeptics of the L3C, have premised parts of their respective critiques of the L3C on the idea that it is an unnecessary addition to state LLC statutes. Kleinberger notes that “there is nothing an L3C can do that cannot already be done through an ordinary LLC.”⁹⁵ Bishop elaborates on this view, stating: “L3C statutory operating restrictions could be added in an LLC operating agreement or its articles of organization.”⁹⁶ While the L3C form may have a branding advantage, “the statutory form carries no advantage

⁹³ Brakman Reiser, *supra* note 60, at 650.

⁹⁴ Brakman Reiser, *supra* note 85, at 111. One important example of this branding effect is the B corporation, another type of mission and profit hybrid entity. B corporations are required to undergo a certification and audit process through an independent body, B Lab. This kind of audit process provides some assurance to investors of mission impact and mission-motivated decision-making processes. See Brakman Reiser, *supra* note 60 (providing analysis of B corporations vis-à-vis L3Cs).

⁹⁵ Kleinberger, *supra* note 24, at 897.

⁹⁶ Bishop, *supra* note 16, at 249.

to similar contractual expressions in the articles or operating agreement.”⁹⁷ Of course, an LLC operating agreement with strict provisions on the required priority of charitable purpose could, in fact, prove to be the most reliable means of ensuring charitable priority because it could be the most narrowly tailored. For example, an operating agreement could not only mandate that the LLC further a charitable purpose; it could also prescribe appropriate measures for the enforcement of that purpose.

B. An Information Return

If Oregon or other states do choose to adopt L3C enabling statutes, these statutes should include a provision requiring L3Cs to complete an annual information return, filed with the Secretary of State and available to the public, to supplement the annual report required for all LLCs.⁹⁸ States could require L3Cs to provide some limited financial disclosures as well as information on how decision-making processes are structured to ensure charitable primacy. This kind of transparency would have at least three crucial benefits. First, it could give oversight authorities a tab on L3C charitable work. Second, it could provide current and future L3C investors with a metric on the impact of their dollars. Third, it could serve as a general check against charitable mission drift.

An information return would serve as a critical tool for oversight authorities. Currently, most states with L3C statutes do not vest regulatory authority in a particular department or individual. Even in Michigan and Wyoming, where specific authorities are charged with enforcing L3C accountability for their charitable purposes,⁹⁹ these authorities have no metric or tool for carrying out such enforcement. Without such a metric, regulating authorities will have little means or motivation to effectively assess the charitable impact of L3Cs, and thus, no clear way to hold an L3C accountable for prioritizing its charitable purpose.

⁹⁷ *Id.*; see also J. William Callison & Allan W. Vestal, *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures*, 35 VT. L. REV. 273, 291–92 (2011) (arguing that the L3C designation could be distracting and misleading).

⁹⁸ See, e.g., OR. REV. STAT. § 63.787 (2011).

⁹⁹ See MICH. COMP. LAWS ANN. § 450.4803 (West, Westlaw through P.A. 2012, no. 297); WYO. STAT. ANN. § 17-29-705(e) (West, Westlaw through 2012 budget sess.).

An information return would also be an invaluable tool for investors. Regardless of whether an investor is drawn to L3Cs to invest for market reasons or charitable reasons, she will have a strong interest in understanding the businesses' operations and impact. In order to empower investors to most effectively assess the impact of an L3C, a mandatory public disclosure is essential: the uniformity of such a disclosure would enable an investor to compare L3Cs against their peers. In addition, a mandatory disclosure provides a baseline to L3C investors and non-investor stakeholders, such as employees and clients, to determine additional disclosures and information they may want to seek.

Finally, an information return would serve the invaluable role of a general check against charitable mission drift or skewed priorities. Ultimately, without such a check, the other stakeholders in an L3C will have little motivation to ensure that charity remains the primary priority in an L3C. Private foundation staffs do not have time to police the charitable impact of their investment. Further, other investors are unlikely to ask questions if they are receiving satisfactory returns on their investments. In such an environment, income could easily overtake charity as the primary priority. With the promise of an L3C's charitable purpose at stake, a public information return adds a layer of authenticity and accountability. While the filing of a return is not a perfect check on an L3C's charitable priorities, it certainly acts as a first step in orienting a business toward the nebulous question of charitable impact. Moreover, because L3Cs will be eager to attract investors who are drawn to charitable impact, it will motivate L3Cs to take these metrics seriously.

There are already steps in place toward some kind of information reporting for L3Cs, making this approach particularly feasible. Proposed federal legislation includes provisions requiring any organization that receives a PRI to report on certain aspects of the PRI.¹⁰⁰ Reporting requirements include questions on what the PRI recipients are doing with the investment, how the recipients are ensuring the PRI complies with the IRS rules, which foundations are making PRIs, and how often and for what purposes investments are being made.¹⁰¹ This kind of reporting is appropriate for all L3Cs, not solely L3Cs receiving PRIs. Even if an L3C receives no PRIs, this

¹⁰⁰ See H.R. 3420, 112th Cong. (2011); *see also* Brakman Reiser, *supra* note 85, at 113.

¹⁰¹ See H.R. 3420, 112th Cong. (2011).

reporting would give the L3C's current and potential investors a public metric for understanding its charitable impact.

C. Explicit Oversight Authority

In addition to mandatory information reporting, all state L3C enabling legislation should include an explicit recognition of oversight authority.¹⁰² This provision is a necessary companion to mandatory reporting as it would vest authority in a specific person or office to enforce reporting requirements and investigate or put pressure on an L3C failing to meet those requirements.

Naming an oversight authority has multiple benefits. First, the knowledge of oversight would encourage L3Cs to produce reliable information returns under a statutory scheme that imposed such returns. Second, oversight would enhance the public's confidence in making investments in L3Cs. Third, coupled with an information return, an oversight authority would lend a welcome air of legitimacy to the L3C brand.

CONCLUSION

As the field of charitable and mission-driven work continues to rapidly change, new and creative approaches that bring together the sometimes competing priorities of funders, organizations, and charities will not only be helpful, but necessary. While the L3C is a strong example of creative thinking in this arena, this type of business entity is saddled with disadvantages and uncertainty. Most critically, the L3C form's promise of charitable purpose is not subject to a reliable system of enforcement. Without oversight or enforcement firmly in place, no adequate tools exist to hold L3Cs accountable for prioritizing their stated charitable purpose.

If Oregon chooses to reconsider L3C legislation, it can set the tone for an approach to the L3C that helps to ensure a charitable priority. This approach also aids all stakeholders—including private foundations and other investors—in assessing charitable impact. By following the lead of Michigan and Wyoming and vesting oversight authority in a particular individual or department, Oregon can bolster the charitable credibility of the L3C form. Requiring an annual information return will further add to that credibility. With some

¹⁰² See MICH. COMP. LAWS ANN. § 450.4803 (West, Westlaw through P.A. 2012, no. 297); WYO. STAT. ANN. § 17-29-705(e) (West, Westlaw through 2012 budget sess.).

structure for oversight in place, the L3C form can better accomplish its promised ends: a contemporary approach to mission-driven work, an infusion of new capital in the charitable field from investors who have not previously been involved, and a renewed energy from foundations and donors who have long been champions of charitable work.